

Internal Revenue Service  
**memorandum**

CC:TL:PL  
date: TWVincent  
APR 8 1991  
to: District Counsel, San Diego CC:W:SD  
Attn: Frank Bailey  
from: Assistant Chief Counsel (Tax Litigation) CC:TL

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subject: [REDACTED]

This is in response to your request for tax litigation advice dated January 30, 1991.

ISSUES

1. Are the agents who are conducting an investigation of nondocketed tax years prohibited from informally requesting information from third parties concerning a prior tax year that is docketed before the Tax Court in an attempt to develop a pattern of fraud for the nondocketed tax years.

2. If the agents are prohibited from requesting this information, would such action by these revenue agents be grounds for dismissal of the Tax Court proceeding and for the imposition of attorney's fees in favor of the petitioner.

CONCLUSIONS

1. It is our view that the agents are not prohibited from requesting the information sought to develop the fraud issue for the years under investigation.

2. In view of our position that the action of the agent is not prohibited, we take the position that such action is not subject to sanction.

FACTS

Revenue agents have been conducting an examination of contractors in Arizona who are suspected of having received but omitted taxable income from their tax returns for the years [REDACTED]-[REDACTED]. During the investigation, the Service requested the taxpayers to sign agreements to extend the statute of limitations. One such contractor, [REDACTED], refused to do so. Facing the three year limitation period and having insufficient information to allege fraud, a notice of deficiency was sent to [REDACTED] for his [REDACTED] tax year. [REDACTED] filed a petition with the Tax Court on [REDACTED]

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The agent continued to develop the [REDACTED]-[REDACTED] tax years. On [REDACTED] the agent sent informal requests for information to third parties. In attempting to develop a pattern of fraud, these requests sought information for the tax years [REDACTED]-[REDACTED]. The information sought was not intended to assist the District Counsel attorney in the litigation of [REDACTED]'s [REDACTED] tax year. At the time the requests were sent, the attorney assigned to the docketed case was not aware that the agent was soliciting information that related to the docketed year. Upon learning of the requests, counsel instructed the agent to terminate his investigation with respect to the year presently docketed before the Tax Court. Counsel has not attempted to obtain the assistance of the agent nor to utilize any information the agent may have obtained during the investigation to develop the docketed case.

Petitioner has filed a Motion to Dismiss and For Sanctions alleging respondent's examination violated the Tax Court's Rules of discovery. Petitioner is seeking a dismissal under Tax Court Rule 123 and attorneys fees.

#### DISCUSSION

1. Although he does not refer to any case law, petitioner's motion is seemingly based on Universal Manufacturing Co. v. Commissioner, 93 T.C. 589 (1989), and Westreco, Inc. v. Commissioner, T.C. Memo. 1990-501, in which the court held that it had the authority, under the facts of those cases, to prohibit the use of materials and information obtained pursuant to summonses and information requests occurring outside of the court's discovery processes. On March 11, 1991, the Tax Court issued its opinion in Ash v. Commissioner, 96 T.C. No. 16, which modified the holdings of both Universal Manufacturing Co. and Westreco, Inc., and, in our view, represents a considerable retraction of the principles established in those cases. Additionally, this case is factually distinguishable from those cases, and consequently, the court need not reach the question of the extent to which Ash, Universal Manufacturing Co. and Westreco, Inc., apply to the instant case.

In his motion, petitioner's counsel argues that respondent's actions in seeking information from third parties for a year that is pending in the Tax Court circumvents the court's discovery rules. Petitioner's position is somewhat akin to that presented in Universal Manufacturing Co., wherein the court ruled that respondent's use of compulsory administrative summonses to interview third party witnesses and obtain relevant documents concerning the issues in the cases pending before the court circumvents the court's discovery rules. As noted above, however, the court has significantly modified the holding in Universal Manufacturing Co. in Ash.

In Ash, the Tax Court reviewed the court's prior opinions in Universal Manufacturing Co. and Westreco, Inc.. Regarding the use of summonsed materials in docketed cases, the court in a reviewed opinion held as follows:

1) With respect to summonses issued prior to the filing of a petition, the court refused to extend the holding in Universal Manufacturing Co. to bar the use of information obtained after the filing of the petition. The obligation under such summonses to provide information is established prior to the Tax Court obtaining jurisdiction, and any summonses issued by respondent at that time do not pose a threat to the integrity of the court's discovery rules.

2) With respect to summonses issued after the filing of a petition, the court will exercise its inherent powers to prevent abuse, oppression and injustice in the following manner:

(A) When litigation has commenced and an administrative summons is subsequently issued with respect to the same taxpayer and the same taxable year, the court will exercise its inherent power to enforce limited discovery unless respondent can show that the summons has been issued "for a sufficient reason, independent of that litigation."

(B) When litigation has commenced and an administrative summons is subsequently issued for a different taxpayer or a different taxable year, the court normally will not exercise its inherent power, unless petitioner can show "lack of an independent and sufficient reason for the summons."

It is noted at the outset that in this case respondent has not attempted to utilize his summons power. The correspondence petitioner's counsel alleges was improper is merely an informal request to a third party for information. This is not analogous to a compulsory procedure, like a summons, that may compel information beyond that available through the Tax Court's discovery rules.<sup>1</sup> Even assuming that the subject requests had been sent by respondent's counsel, such requests would nonetheless have been proper, and in fact required, under the court's discovery rules, which provide that the parties are expected to utilize informal communication before using formal

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<sup>1</sup> In Universal Manufacturing Co., the court restricted its ruling specifically to a situation in which respondent was proceeding under his broad summons power. The court made this distinction by stating the court's "objective is to require respondent to present his position in the civil cases pending before us without utilizing any information obtained pursuant to an administrative summons . . . ." 93 T.C. at 595.

discovery. See Ash, supra, slip op. at 8, citing T.C. Rule 70(a)(1) and Branerton Corp. v. Commissioner, 61 T.C. 691 (1974). See also Tax Court Rule 75(b), which provides that informal attempts to obtain information from third-party witnesses must be made before a party can utilize the court's nonconsensual discovery deposition procedures. Informal requests by respondent's agents therefore cannot be said to give respondent a more advantageous position than he would have by proceeding under the court's discovery rules.

Moreover, even if the court were to deem the inquiries made in this case the equivalent of summonses, under the standards summarized above, respondent need only show that they were made "for a sufficient reason, independent of [the] litigation." This burden may be met by demonstrating that the inquiries were made by an agent who was attempting to establish a pattern of conduct sufficient to sustain the assertion of fraud in years not before the Tax Court. The information sought was not intended to assist in the litigation of [REDACTED]'s [REDACTED] tax year. Respondent's counsel was not requesting nor has he received any information obtained in response to these inquiries. It is our view that these circumstances fall within the "independent and sufficient reason" test set forth in Ash. Therefore, the prior actions of the agent in requesting information from third parties would not be deemed improper.

2. Based on the foregoing conclusion that the actions of the agent were not improper, such action is not subject to sanction. Even assuming, however, that petitioner's motion is well taken, it is our view that petitioner's request for default as a sanction may not be granted. Respondent has not "failed to plead or otherwise proceed as provided by [the Court's] Rules or as required by the Court," the only basis upon which default can be entered under Rule 123(a).

In addition, such a dismissal would be erroneous as a matter of law as a violation of the principles reflected in Rule 55(e) of the Federal Rules of Civil Procedure. That rule provides that "no judgment by default shall be entered against the United States or an officer or agency thereof unless the claimant establishes his right to relief by evidence satisfactory to the Court." Additionally, I.R.C. section 7458 provides that notice and opportunity to be heard must be given to the taxpayer and to the Secretary in any proceeding instituted before the Tax Court. See Board of Tax Appeals v. United States ex rel. Shults Bread Co., 37 F.2d 442 (D.C. Cir. 1929), cert. denied, 281 U.S. 731 (1930); see also Kumpf v. Commissioner, 682 F.2d 67 (3d Cir. 1982). A sanction of default, which deprives the opportunity for a defense to be heard on the merits, would be erroneous as a matter of law.

CONCLUSION

We recommend that you defend against petitioner's motion on the basis that the actions by the agent are not inconsistent with or in violation of the Tax Court Rules. The facts of this case concerning the requests by the agent are clearly distinguishable from those of Ash, Universal Manufacturing Co. and Westreco, Inc. Second, under the standards set forth in Ash, the inquiries in question were made for a sufficient and independent reason separate and apart from the litigation. Therefore, the actions taken by the agent were not improper. Based on the forgoing, it is our view that sanctions are not warranted in this case. Lastly, a sanction of default, if a sanction were to be imposed by the court, would nonetheless be erroneous as a matter of law.

We also advise that a written objection be filed with the court addressing the facts of this case and the application of the Ash standards outlined above. An affidavit by the agent conducting the investigation should be attached to the objection. The affidavit should provide support for counsel's lack of involvement in the investigation and the "independent and sufficient reason" test set forth in Ash. Please FAX (FTS 377-6298) your objection to this office prior to filing with the court. Any questions regarding this matter should be addressed to Terry Vincent or Richard Goldman at FTS 566-3257.

MARLENE GROSS

By: 

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